Ceradyne is up 75% since November but still has a P/E of less than 13. Click here for more undervalued best buys in Upside.

A common stock’s ex-dividend price behavior is a continuing source of confusion to investors.

How Does It Work?
Suppose we have a company called Jack Russell Terriers Inc., which trades on the Nasdaq under the truly appropriate symbol of "HYPER," and is currently trading in the market for $10 per share. Due to the popularity of Jack Russell Terriers, HYPER has had record earnings, so the board of directors decides to declare a special extra dividend of $1 per share with a record date of Tuesday, June 12, 2007. The ex-date will be two business days earlier, on Friday, June 8.

If you own the stock on Thursday, June 7, you will get the $1 dividend because the stock is trading with (or "cum") dividend. If you wait to own the stock on Friday, June 8, you are not entitled to the $1 annual dividend. Keep in mind that the purchase date and ownership dates differ. At this time, the settlement date for marketable securities is three days. So, to own shares on Thursday, June 7, the actual trade must take place on Monday, June 4. (For additional information on the stock settlement procedure, see "The Nitty-Gritty Of Executing A Trade.")

Special Offer: Seek strength in a weak market. Go with dividend ETFs for a margin of safety in your investing. Jim Lowell rates both the PowerShares International Dividend Achievers (PID) and WisdomTree International Small Cap Dividend (DLS) as "buys." Click here for the complete ETF model portfolio in Forbes ETF Adviser.

The Stock’s Value
What will happen to the value of the stock between the close on Thursday and the open on Friday? Well, if you think about it within the context of actual value, this stock is truly worth $1 less on Friday, June 8 than it was on Thursday, June 7. So, its price should drop by approximately this amount between the close of business on Thursday and the open of business on Friday.

In general, we would expect that the value of a share of HYPER stock would go down by about the dividend amount, $1, when the stock goes ex-dividend. The term "about" is used loosely here because dividends are taxed, and the actual price drop may be closer to the after-tax value of the dividend. This is a bit difficult to measure, as different tax rates and rules apply for different buyers, but it would be safe to assume that it should drop about 15%, as HYPER pays a qualified dividend.

Let’s say that Bob is excited about HYPER’s earnings and buys 100 shares on Monday, June 4 at a price of $10 per share. What happens? As you know, the ex-date is two business days before the date of record, Tuesday, June 12. The stock will go ex-dividend (trade without entitlement to the dividend payment) on Friday, June 8, 2007. Bob owns the stock on Thursday, June 7, so he purchased the stock with entitlement to the dividend.

In other words, Bob will receive a dividend distribution of $100 ($1 x 100 shares). His check will be mailed on Wednesday, June 13, 2007, (dividend checks are mailed or electronically transferred out the day after the record date). When the stock goes ex-dividend on Friday, June 8, its value will drop by about $0.85 ($1 x 0.85 [1 – the tax bracket]). So, on the following day, in theory, the stock should be trading for approximately $9.15 (or $10 – $0.85).

Think Before You Act
Now that you understand how the price behaves, let’s consider whether Bob needs to be concerned about this or not. If he is buying HYPER in a qualified account (in other words, an IRA, 401(k) or any other tax-deferred account), then he should not worry
too much because taxes are deferred until he withdraws his money or, if he makes his purchase in a Roth IRA, are not due at all.

However, if Bob buys HYPER in a non-qualified, currently taxable account, he really needs to be careful. Let's say Bob just can't wait to get his paws on some HYPER shares, and he buys them with a settlement date of Thursday, June 7 (in other words, when they are trading with entitlement to the dividend). He pays $10 per share. Suppose that the very next day, HYPER drops to approximately $9.15. Bob will have an unrealized capital loss and, to add insult to injury, he will have to pay taxes on the dividend he receives. Bob's portfolio will lose money and he will owe money to Uncle Sam on the $100 in dividends that he receives. Clearly, Bob should have bought HYPER shares on the first ex-dividend day and paid the lower price, allowing him to avoid owing Uncle Sam taxes on the $0.85 he lost.

**Additional Considerations**

This scenario also needs to be considered when buying mutual funds, which pay out profits to fund shareholders.

By law, mutual funds must distribute profits from the sale of securities in the fund to the fundholders each year in the form of income dividends and/or short- and long-term capital gains, even if the value of their actual mutual fund's net asset value drops. This distribution to the fundholders is a taxable event, even if the fundholder is reinvesting dividends and capital gains.

**Special Offer: Profit from volatility, literally. You can buy options on the VIX. What's the smart call for the direction of the fear gauge for the next two weeks? The right position can mean triple-digit percentage returns in 10 trading days. Click here for Larry McMillan's August expiration put and call buys in Option Strategist.**

Why don't mutual funds just keep the profits and reinvest them? Under the Investment Company Act of 1940, a fund is allowed to distribute virtually all of its earnings to the fund shareholders and avoid paying corporate tax on its trading profits. By doing this, it can lower fund expenses (taxes are, of course, a cost of doing business), which increases returns and makes the fund's results appear much more robust.

What's an investor to do? Well, just like the HYPER example, investors should find out when the fund is going to go "ex" (this usually occurs at the end of the year, but start calling your fund in October). If you have current investments in the fund, evaluate how this distribution will affect your tax bill. If you purchased shares that are currently trading for less than the price you paid for them, you may consider selling to take the tax loss and avoid tax payments on the fund distributions. If you are thinking about making a new or additional purchase to a mutual fund, do it after the ex-dividend date. (To read more on this subject, see "Selling Losing Securities For A Tax Advantage.")

It's not what you earn--it's what you keep--that really matters. Being mindful of these ex-dividend circumstances should help you keep more of your hard-earned dollars in your pocket and out of Uncle Sam's coffer.

**More Investor Education Columns**

Send comments and questions to newsletters@forbes.com